

Mphasis Limited

View Point

Event : HP to Buy EDS for \$13.9 Bn.

Hewlett-Packard Co. has agreed to buy Electronic Data Systems Corp. for \$13.9 billion, including \$25 per share in cash and the assumption of some debt. The deal is valued at 0.61x EV/FY08E Revenues or 4.9x FY08E EV/EBITDA. The Transaction is expected to be closed in the second half of calendar 2008. The deal is expected to strategically increase HP's competitiveness in Applications business.

This acquisition will increase the combined market share of EDS (4% now & World No 2) and HP (3% currently) to 7% within the IT services space. While HP would leapfrog its position from No 5 to No 2, the combined entity still remains second to IBM at 10% global market share. However, it is pertinent to note that within the sub-segment of Applications Outsourcing, the HP-EDS combine would be the new world No 1 with ~20% market share.

HP will use the brand "EDS - an HP company" for the acquired operations, which will continue to remain headquartered at Texas.

What is important for us, is to cipher the impact for 'Mphasis Limited', the Indian listed subsidiary of EDS, in terms of operating panorama and as a possible de-listing candidate.

Firstly, our prognosis on the operating scenario.

California based HP is an IT giant with a lion's share of its overall revenues coming in from Products business. IT services business, though decent at \$16.65 Bn. (2007) is just a small portion of the overall \$105.71 Bn. (2007) business of HP.

EDS is a Texas based IT Services major which did \$22.13 Bn. of business in 2007 on the back of its 1,37,000 employees of which a formidable ~45,000 employees are based offshore (best shore as referred by EDS).

Mphasis is a 61% subsidiary of EDS. EDS acquired a controlling stake in this listed Indian corporate in 2006 and later merged its Indian operations in 'EDS India' with this listed entity to increase its stake holding to the present 61%. Mphasis including EDS India has about 28,000 employees and is a key to EDS' best shore policy. Mphasis did Rs. 24,231 Mn. (\$0.6 Bn.) business in fiscal 2008.

HP has its separate business operations in India. It has employed ~31,000 people. As per print sources, HP India did ~ Rs. 12250 Crs of revenues, but largely from selling hardware. HP in India has won several small IT outsourcing contracts from BOB, BOI, Airtel, etc. HP India's services revenues from outsourced IT services were \$150 Mn. in 2006-07 and increased significantly to Rs. 16.6Bn in 2007-08.

HP's services division and EDS will have a combined headcount of about 209,000 workers. HP (Parent) and EDS, though in the same business are quite diverse in terms of culture, clientele and to some extent in terms of business segments. Also, as far as services are concerned, HP has acquired a much bigger company. Ergo, we would certainly not expect HP to integrate the operations of the Texas major, in its quest to bring about synergies, particularly since Services companies tend to develop unconventional cultures as well.

However, we feel that there is a greater likelihood of bringing about some cost savings through layoffs at the EDS end. Here's why.

Quotes from the two chiefs

"There are obviously going to be some changes"; said Rittenmeyer EDS - Chairman, President & CEO

"But clearly, we wouldn't do the deal if we didn't think we had an opportunity to improve the operating profit levels that EDS currently has"; said Mark Hurd - Hewlett-Packard - Chairman, President & CEO

Overall, on the operating front, we expect minimalistic changes. Its certainly more of cost cutting rather than revenue synergies. This we feel augers well for Mphasis. To simply put it, Mphasis was important to EDS and now should continue to be so for the HP-EDS combine.

We expect no changes to be warranted in our near term estimates for Mphasis. Only in the longer run, we may see some positive triggers to set in for Mphasis from the HP channel, just like the way it is coming in from the EDS route. This would further place Mphasis very well as an MNC play, amidst its other listed Indian peers, with great revenue visibility at least sales efforts.

Now the second big question. Would HP de-list Mphasis?

While EDS was unable to get Mphasis listed, it had also clearly expressed its comfort to have Mphasis continue as a listed entity, similar to the way Hindustan Unilever is to Unilever Plc. However, the new parent HP may not share the same comfort as it comes under scanner/pressure to rationalize the overall EDS operations with a third-party publicly traded entity in India.

One may recall that when HP acquired Compaq in late 2003, it got the latter's subsidiary Digital Globalsoft de-listed at a final price of Rs. 850 per share as compared to the price of Rs. 560 prevailing at the time of the acquisition. However, Compaq like HP has been a product company primarily with greater synergies and lesser cultural issues. Even Digital Globalsoft was eventually & soon fully integrated within the HP fold of operations.

This is what differs for the services centric Mphasis & EDS. While de-listing provides a window for some windfall returns for the minority stakeholders, history suggests a mixed bag of successful de-listing initiatives. Before the de-listing prospect, it is also unclear if the open offer rule would get triggered for this yet another case of an MNC parent of an Indian listed company being taken-over internationally. We have conflicting examples of Gillette India & United Breweries on one hand and Fairfield Atlas on the other. Again, should an open offer get triggered, one may not

be able to say with total conviction that the open offer sets the bottom threshold for the scrip price. We have come across recent instances in case of Mphasis itself and also Iflex, where the scrip traded at a decent discount to the last price tendered in the open-offer by the new parent for a reasonable time.

Also the Indian arm of HP like the US parent is primarily into products business, and there is no point in getting this company merged with Mphasis and get the operations for public examination. Also Mphasis has a good 39% with outsiders & so a lot would need to be done to take the story from an open-offer to a successful de-listing.

The best possible route at the option of the new management would be to separate the services business of its Indian arm, HP India (small in % but decent in absolute value) to merge with Mphasis (Just like EDS India) and effectively increase its stake in the listed entity significantly higher at say even over 80%. Its then, that it would be practically easy & feasible to execute a de-listing process. While the management benefits from the valuation process and the stake increase, the current outsider stakeholders in Mphasis would get their surpluses from the de-listing premiums.

But does it matter, when Mphasis is just \$0.6 Bn in comparison to the HP's present \$106 Bn. and HP-EDS effective combine of \$133 Bn. ? Well, the foreigner's have time till 2nd half of 2008 to get the merger done and a little more to ponder over the need for our much awaited de-merger.

We remain extremely bullish on Mphasis in the longer run on account of the increasing revenue visibility on moderating efforts. Lastly, the new silver lining is that, Mphasis' delisting & merger may expedite incase US actually introduces the proposed 50:50 law for 50% local hiring. Until then, we maintain our quarterly near-term target of Rs. 260 per share, without factoring any spikes for a possible buy-back offer.

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